# THE RAILROAD RATE DECISION

BY J. SHIRLEY EATON

On February 25th the Interstate Commerce Commission rendered its decision denying the advances asked for by the railroads of the Western Traffic and Official Classification territories, which embrace the principal roads north of the Ohio and east of the Mississippi rivers. The case had been, perhaps, the most hotly contested and long-drawn-out battle yet waged before this tribunal. Two hundred and forty-one railroads were involved. The actual money at stake was about one per cent. of the entire railroad earnings of the country, but in many respects the case was construed to be a test case to sound the policy of the commission in the exercise of the great extension of power granted it by the Mann-Elkins Act which became effective June 18th, 1910. Furthermore, the waiting attitude in business and the universal stress of high prices had turned the public mind upon economic questions. The enormous purchasing-power of the railroads whose credit and resources were alleged to be in jeopardy gave immediate practical bearing to the controversy throughout the country. There was evoked a flood of interviews, letters, magazine articles, and expressions generally by persons of all degrees of information. In the broader outlook these expressions, equally with the formal testimony at the hearing, have been potent in shaping public opinion. The railroad men were drawn from their routine tasks of rate-making, railroad operation, and finance into discussions of public policy and fundamental socio-economic principles that were academic, but at the same time terrifically practical.

In the first six months of 1908 the railroads felt acutely the depression dating from the fall of 1907. The steady advance in prices and wages, coupled with a halt in the advance of gross earnings, made the problem of railway man-

agement a serious one. Since prices and wages had so great an increase, why, reasoned the railroad men, should railroad rates be excepted from the universal tendency? The railroads, therefore, asked for more revenue on the ground that it was necessary to sustain their credit. The advance in the West was upon some two hundred "commodities," which are articles of raw material or special condition justifying separate rates for each. The increase of the railroads of the East was made largely in the class rates. A notice of the increase of rates was filed with the Interstate Commerce Commission June 1st, 1910. The commission requested the carriers to defer the date when these rates should become effective until November 1st. Meanwhile the Mann-Elkins Act became a law.

By this law the commission was empowered not only to pass upon the reasonableness of a rate in effect, but to deny a proposed new rate until the decision was reached as to its reasonableness after a hearing in which the burden of proof of such reasonableness of the rates proposed was on the carriers. The present case was considered from three standpoints:

1. The effect of the rate on the shipping public.
2. The effect upon the railroad.
3. The effect upon general public policy.

Because the case was not restricted to a limited number of rates or to a few competitive points it was different from most of those which have come before the Interstate Commerce Commission. It bore disproportionately on no one commodity nor market, and therefore it was not a contest between different producers or rival markets, but squarely an issue between the railroads and the public in the person of the ultimate consumer to whom the burden would eventually be shifted by the shipper. As an indirect tax spread over a multitude of articles its identity was lost and it became practically a negligible quantity.

The usual criteria of the reasonable rate have been the existing rates on like articles under like conditions and generally in the same or neighboring localities. Obviously in a horizontal advance which in the Western territory affected 200 commodities over their long-distance routes and in the East affected the six classes and four sub-classes with some 150 commodities, these usual measures for determining the reasonableness of the new rates did not apply. The idea

underlying the fairness or reasonableness which it is undertaken to prove by such comparisons is that the burden shall be equally distributed in the proportion that each is able to bear it. This, in passing, is a very different matter from imposing on *one*, all that this one may be able to bear, irrespective of the pressure at other points. For the foregoing reasons, considerations advanced in this controversy were necessarily upon broader ground than in most cases before the Interstate Commerce Commission.

Obviously, again, any rate which the railroad might make would be less than it would cost the consumer to perform the service for himself. It was, therefore, plainly impossible to determine the reasonableness of the rate from the standpoint of the consumer. The question shifted thus at once to the consideration of the reasonableness of the rate from the standpoint of the railroad. In this connection there was much loose expression about a reasonable rate as being based upon the notion of a " fair return." This fair return was, in some confusion, referred to at times as if it could exist as a thing apart from the capital invested when such investment was so large or was under such conditions of public regulation as to be practically of the character of monopoly. The words " fair and reasonable " were interchangeably used throughout the hearings, in a vague way, without relevancy to anything determinable. President Ripley of the " Atchison," when pressed for a criterion as applied to rates, found it in some unexplained intuition. He would not make a two-hundred-per-cent. increase in rates because " it would be a shock to my sense of propriety—a shock to my sense of justice " — not " fair or decent or proper."

A reasonable rate for a railroad is one that will yield a reasonable profit. The issue before the commission turned on the definition of what constitutes such just earning-power. The President of the Pennsylvania Railroad declared that a reasonable return was seven per cent. President Willard, of the Baltimore and Ohio Railroad, set the mark at six per cent., as did the President of the " Atchison." It was brought out that in the past decade, by natural processes, the character of railroad investment has greatly changed; the highly speculative features have disappeared; the prospect of frequent " melon-cuttings " is no longer a factor to offset a nominal rate of regular annual return. For this

reason, it was claimed, the regular dividend should be higher than in past years.

With the direct return, the railroad men urged, should go a surplus to serve as a safety factor to provide for contingencies and to meet the increasing demand for better service which results in a large non-productive application of capital, such as that for passenger terminals, grade separations, block signals, and electrification. The Pennsylvania Railroad has increased its investment in property $288,000,000 in ten years. In this time the gross earnings increased $66,000,000, but the expenses increased $52,000,000, leaving $14,000,000 of net earnings, which is $3,000,000 less than six per cent. on the additional investment to produce it. On this road it has been the policy to set aside one dollar for betterments and one dollar for dividends. On the Baltimore and Ohio Railroad the disposition of surplus has been fifty cents to betterments for one dollar to dividends.

But, the shippers questioned, if these reserves were created by excessive rates, are they the property of the railroad or the public? Furthermore, if they are to protect the railroad against conditions beyond its control, what fixed relation can these conditions have to dividends on the stock which on some basis are, with these reserves, to share surplus earnings?

This surplus for reserve, together with the direct return, were held to be of co-ordinate importance in insuring the credit of the railroad. It was shown that the relation of the railroad to its stockholders, and in this way to the funds available for investment, was not merely a sentimental one resting on the considerations of trusteeship involved, but an imminently practical one. The railroad must be able to draw from these public investment funds at will and so continue to expand with the growth of the communities served. Anything that tends to impair its credit and imperil its relation to the vital sources would stop growth, jeopardize its present investment, and destroy its function in the country's expansion. Opinions were quoted to show that the railroads were physically behind the growth of the country and that extraordinary developments were necessary to regain the ground already lost. Mr. Willard referred to the statement of Mr. J. J. Hill, President of the Great Northern, in which he said that $1,000,000,000 a year for five years would be required for this purpose. Such money, it was urged, is

gravely needed for double-tracking, for revision of terminals, reduction of grades and curves, and replacement of rail and power by heavier rail and larger power. The failure to meet this situation might shortly amount to a national calamity by choking the arteries of a country of wide reaches where cheap transportation is a vital need.

Having variously defined the return upon capital adequate to protect the railroad's credit, the next step, which was the vexatious one, was that of designating what that investment is. Original cost, present valuation, cost of reproduction, the railroad property account, and market value of securities were variously offered. If it were original cost, railroad capital would be allowed none of the unearned increment which capital in all other forms of investment expects from the natural growth of business. The Iowa farm values could increase one hundred per cent. in ten years, but the capital invested in the railroad, which was a determining factor in the increase of these values, would have no share in such enhancement. Capitalization based upon the cost of reproduction also cut off the unearned increment except for the enhanced land values at terminals, which are only a part of the railroad investment. The present valuation basis is the cost of reproduction modified by allowance for the physical depreciation of the parts of the plant where it applies, and therefore is under the same limitation as the foregoing. But present value and cost of reproduction would include any values added out of earnings; if the railroad enjoying extortionate rates had thus reinvested in the property its surplus above a reasonable dividend, could adjustments of capital derived from the public in this way be allowed to render reasonable a rate originally extortionate? A case in point was offered by the Chicago, Burlington, and Quincy Railroad. The original investment was $258,000,000, but present value is $535,000,000. The difference is $277,000,000. This fund may have been derived from excessive rates or from deferred dividends of lean years or from the general increase of property values in the territory served—to whom does the fund now belong?

Having alluded to the necessity for defining an investment by determining some of the conditions of its operation, the question next arose, what examples of actual capitalization should be taken as a fair standard by which to measure all others? The "Lake Shore" earned in one year twenty-

five per cent., the "Lackawanna" forty-nine per cent., while the Chicago and Northwestern earned one hundred per cent. in ten years. A reasonable rate cannot be made for each road; in such diversity, which road shall be taken as the type to which the others shall be forced into conformity? In making them conform, we are arbitrarily equalizing conditions which are partly differences of initial strength, of foresight, and of management. To socialize these differences is to eliminate the qualities on which economic efficiency is worked out. One suggestion was that the excess profits of the prosperous roads should accrue to the State. The representative of a great firm of accountants would raise to an "equitable basis" the rates disproportionately low, and then, having equalized the difference of the several roads, he would make such general advances as would enable the roads to earn a proper return. Altogether this is a mere permutation of words of the same generic intention.

Given a notion of a fair return and of proper investment, there still remained the third term of *fair efficiency* of operation to complete the formula. The brilliant counsel of the Commercial Organization of the Atlantic Seaboard threw much of the weight of his argument on this point. He adduced the experience of efficiency engineers to show in the industries results to which the railroads had no counterpart. He dramatically claimed that the railroads could save $1,000,000 a day by the introduction of scientific management, and immediately the half-score of pioneers—Taylor, Gilbreth, Emerson, Gant, Barth, and others—who had been pushing their theories in obscurity were in the full blaze of publicity. The American railroad man has so long challenged the world that he was unprepared for this flank attack.

The abstruse and vexing socio-economic questions to which each trail seemed inevitably to lead forced the railroads to present their case by charting their present business against the background of the operations of other years and the tendencies in other businesses. The increase in prices of lumber, ties, coal, and other material, and especially heavy wage increases, were offered as reasons for rate advances. The effect of these price and wage changes was shown in the increase in the ratio of expenses to earnings. President McCrea testified that this ratio had jumped from 69.7 per cent. in 1909 to 75.51 per cent. in 1910; in his opinion it will

not go back. The last ten years have seen great increase of railroad operating efficiencies, but he maintained there is a limit to the grades that can be cut down and the curves that can be eliminated. Furthermore, he believed the period of great economic expansion in the East to be passing. Henceforth the railroads would devote themselves to the steady routine of serving settled communities: railroad properties had not the resiliency they once had. In this view the experience of the past years, with their enormous expansion, was a doubtful guide in estimating future earnings.

The reasonableness of a general rate increase as affecting public policy would manifest itself at two points—namely, in the credit of the railroads both at home and abroad and in the length of the radius of distribution from producing points. The credit of the railroads was held to be compromised by the increasing operating ratio brought about by the requirements of more expensive service, the impositions of labor organizations, and the rise in prices. Evidence of this disturbance of railroad credit was the amount of financing done on short-term notes. The situation was further complicated by the fact that the underlying liens had all been exhausted in earlier financing. Railroad securities had come to be the great form of public investment which would be sensitive to any arbitrary action by the commission in disturbing railroad values. The President of the Home Life Insurance Company testified that 37.5 per cent. of the assets of his company are in the form of railroad securities. The life-insurance companies operating in New York, which have 20,000,000 policy-holders, own about one-eighth of all the railroad-funded securities. The *Commercial and Financial Chronicle* roughly estimates the amount of such railroad securities held by insurance companies, together with savings-banks and endowed philanthropic and educational institutions, to be $1,750,000,000.

The public, and especially the railroads, were unprepared for a sweeping denial of all the advances asked, and the first announcement of the decision created consternation among the latter. To the credit of this tribunal, however, there were no advance intimations of its real judicial mind.

Throughout the opinions, which were written by Commissioner Prouty in the case of the Eastern roads and Commissioner Lane in the case of the Western roads, there is a marked consciousness of the importance of their deliveries—

not so much as measured by the immediate issue as in defining the lines of fundamental policy, because the functions of the commission as an economic court are well advanced toward the margin of the experimental.

At the outset the commission laid down the interpretation that the Mann-Elkins Act did not have the result of validating rates existing at the time it became effective, and therefore the commission's prerogative was not limited to the control of subsequent increases only. With this ruling probably was also overthrown the theory that the securities outstanding at that time were by this act validated; therefore, facts as to the original costs of investment prior to the operation of the present law were allowed to enter.

With full admission of the semi-administrative character of their regulatory power the commission refused to recognize the need of raising rates as an artificial stimulus to business, and they passed to the consideration of more permanent factors.

Because not a matter of an individual rate or a group of rates, but affecting thirty per cent. of the revenue of some of the roads involved, the question of the return on the investment became an issue. Railroad testimony had been somewhat confused on this point. The President of the "Atchison" Railroad maintained a very common railroad theory that there was practically no connection between capitalization and rates. Yet, on the other hand, the railroad plea was made largely to protect the credit by maintaining the earning-power of the railroads, which earning-power was based upon the capital invested. The commission had no choice but to take up the question of investment, since it was this, the railroads maintained, that was in jeopardy.

As a first stage in bringing order out of chaos and as a background to their thought, the commission erected an exhibit of railroad operating revenue, expenses, and operating net revenue for a series of years and for the country as a whole. They found an increase in the operating net revenue of about $300,000,000, in eight years. From this they deduced the conclusion that the railroads were enjoying an unprecedented prosperity. Their conclusion was fallacious; as pointed out by the *Commercial and Financial Chronicle,* the figures which they should have used aggregated about $200,000,000, instead of $300,000,000. When, in his opinion, the commissioner elaborated the picture of railroad pros-

perity by stating the dividends, he used grossly misleading figures. The annual reports of the statistician of the commission regularly include a table of the stock-paying dividends in which the duplications due to one railroad owning the stock of another are uncorrected, and another table to the same purport, but in which the stock of one company, held by another company, is not duplicated by the outstanding stock of the second company. Obviously the table having the duplications will lead to erroneous conclusions. The commission used this table. The amount of the misstatement is given below:

DIVIDEND PAYMENTS BY UNITED STATES RAILROADS

| Year— | Commission Figures. | True Figures. | Over-statement. |
|---|---|---|---|
| 1901 | $156,735,784 | $131,626,672 | $25,109,112 |
| 1902 | 185,391,655 | 157,215,380 | 28,176,275 |
| 1903 | 196,728,176 | 166,176,586 | 30,551,590 |
| 1904 | 221,941,049 | 183,754,236 | 38,186,813 |
| 1905 | 237,964,482 | 188,175,151 | 49,789,331 |
| 1906 | 272,795,974 | 213,555,081 | 59,240,893 |
| 1907 | 308,088,627 | 227,394,962 | 80,693,665 |
| 1908 | 390,695,351 | 227,597,072 | 163,098,279 |
| 1909 | 321,071,626 | 236,620,890 | 84,450,736 |
| 1910 | 405,131,650 | (Est.) 240,000,000 | 165,131,650 |

In the East it was estimated that if on the roads asking for the advance the wage increase of 1910 had been in force throughout the year there would still have been an increase over the operating income of the year previous amounting to $16,000,000, while in the West six principal railroads of those involved in the past ten years had accumulated a book surplus of $204,000,000.

So far, in the figures as adduced by the commission, the case was not a strong one for the railroads. The specific item of $35,000,000 wage increase offered by the Eastern roads as a basis for claiming increases in certain freight rates was impugned, because it was not shown that this increase was directly chargeable to the tonnage on which the rate advance had been levied. The commission practically threw out of court the claim that the increase in prices of material had resulted in heavy increases in expenses. This, they maintained, was not proved except in the items of coal, lumber, and ties. These three items constitute over twenty per cent. of the expenses.

The question how the surplus above a reasonable dividend should be disposed of was a troublesome one from which we may hear again. The status of accumulations out of

earnings, together with watered capitalization, was not defined except as it confessedly entered as a contributing factor in the final determination of the case.

The commission dissented from President Ripley's theory that:

"The cost of service is only one of the items to be considered in the making of a reasonable rate and not a very important item at that."

The commission referred to the loose reasoning in the matter as follows:

"While we find the carriers contending uniformly that in the making of a reasonable rate the cost of service is practicably a negligible factor, yet the contention is herein made that the carriers should be allowed to increase their rates upon that ground."

There was a disposition to urge the importance of cost compilations in transportation as in other industries:

"It would be remarkable, indeed, if in this time when all great business enterprises make analyses of costs our railroads should keep no such accounts."

The commission specifically disavowed any intention of interfering with railroad management except so far as they were forced to measure the factors involved by standards of improved practice both in railroads and in other industries. They were inclined to give some credence to the statements that savings in railroad expenses could be made by application of latter-day methods now found in some industries. This disposition was, perhaps, one of the contributing factors, though not a large one, in forming their judgment of the present situation.

The detailed application of the foregoing principles was narrowed by selecting three typical roads in the East and six in the West. The marginal road, they did not feel called upon to protect against the consequences of its past mistakes of policy and management.

The commission threaded their way through a complex of facts and figures with little of precedent or accepted principle to guide them. There were confessedly two issues before the court: the one, the formal question of rate advances; the other, informal and implied,—the exercise of the extraordinary powers, newly conferred, to regulate both in theory and in fact. Those who believe in regulation were reassured when the commission met the challenge squarely; but to the degree that they would respect a court clothed with such

powers, they were humiliated by the grave lack of dignity in the treatment of the case which reached the stage of actual misuse of official figures. The offense is the more serious because it lends itself to further distortion by head-line and catch-phrase journalism. These strictures apply to the opinion in the case of the Western roads. Instead of a story of phenomenal prosperity, careful analysis of corrected figures shows that increased profits of the railroads in the last eight years have just about sufficed to produce five per cent. on the new capital which has been invested.* This misuse of figures is saved from invalidating the decision of the commission, simply because the *entire* earnings of *all* the railroads had the same irrelevancy to the issue of specific rate increases of specific roads as the entire increase in certain wages, which the commission declined to accept in justification. But the injury lies in the effect on the public mind of misstatements by an official body. And this is incalculable.

A decision has been rendered and a case closed, but the educational effect of such a controversy has only begun to be felt. Some things that were undetermined have been defined; other things that were vague are less vague; at least the form of the problem takes shape. Thinking people are filled with dismay or satisfaction, according to their viewpoint, when they realize how much ground has been covered. In the vivisection, in full public view, of a great national industry, laying open all the inner processes of capital in large aggregates, discussion leads inevitably into ultimate questions of private property rights; publicity and privilege are contrary terms.

The intent of a body with such powers as those of the Interstate Commerce Commission is to substitute, through the forms of law and administrative order, for the irregular processes of a reckless, actual competition, the equivalent potential competition. In this, allowance will be made for the play of the constructive socio-economic forces, and by successive stages will be eliminated from it the anti-social forces. As it were, all these different forces are classified, given identity and measure, plotted to scale on the drafting-board, and then set up into a miniature reproduction in plan and elevation of the socio-economic complex to be dealt with. Thus plotted they are broken into their components and reconstructed into resultants by new combinations in which no factor is elimi-

* See *Commercial and Financial Chronicle*, April 1st, 1911.

nated or added, but countervailing (non-social) forces are set against each other to negative each other, and only the net or constructive effect is reproduced in the miniature. Such is at the last the conception of administrative and legal interference in economic affairs. Compelled to define the social function of competition, we find it to be *selection,* the placing of the man—or the economic force at the point of maximum fitness. We may do much of this by a well-tested scale and so save the enormous waste of unregulated competition.

We have gone beyond the stage of idle theory in this matter. Our railroads are reducing their operations to scientific statements where in miniature are set out all the functions in their relations, weighted with their values, grouped into their entities, and carrying forward the net effect through each of the subordinate gradations to the final result in the net income account of the road. It is these accounts which have furnished the terms and the quantities in which the problem before the Interstate Commerce Commission has been discussed. The primary distinction between capital and expenses, between maintenance and betterment, between transportation revenue and outside revenue, has been made. The effects have been traced forward to the surplus account and there we have been pressed for new definitions based on theories of the several factors. Private property which is the direct product of individual effort is a different thing from private property in public service involving associate effort of many men and having a thousand points of contact with other men and other property, its own values resting upon a thousand shifting conditions, physical and economic. We cannot carry over into the second form of property all the notions that applied in the first form of property because the second form of property lacks definiteness and specification, and its boundaries merge into general social considerations at so many points. To whom do the surplus funds belong which are accumulated in these processes? A Western railroad has its controversy with its locomotive engineers in establishing a schedule of pay on the Mallet locomotive. This locomotive is practically two locomotives articulated so as to be under the control of one engineer. The management were ready to pay additional wages, but the engineers demanded twice the wages of the ordinary engineer. In other words, labor proposed to absorb, in the proportion

of its original contribution, the full added efficiency produced by the combination of factors of which it was but one. The rate controversy bristled with questions as to disposition of unearned increment, of differentiated return due to different traffic densities, and even of the savings effected by inventions and special efficiencies. It was in these issues that the contentions as to the disposition of the surplus above a reasonable income centered.

Perhaps the most striking, as certainly the most timely, effect of the rate controversy is the emphasis laid upon efficiency and scientific management. There has been danger that the mechanical engineer has built a machine too large for the administrative man to cope with. The problem of the proper union ot team and individual efficiency, of general ability and specialization, of the individual and the mass, of the central function and the local function, has not been properly studied. In organization the slogan should be decentralization and autonomy.

The efficiency engineers achieved wide publicity for their warning against the enormous wastes of human effort. John Mitchell publicly voiced the protest of labor against the specialization to which he thought labor was driven by the methods proposed. But a rejoinder by one of the efficiency men, Harrington Emerson, indicated that when sanely applied these methods contemplated the individual personality of the worker in an especial way and were connected with certain socializing factors designed to save the workman from the scrap-heap of over-specialization.

There has been injected into business a new factor—an economic court. To this court have been given over some of the functions of private business,—specifically that of controlling and certifying to certain of the factors that make for the financial credit of the railroads of the United States. The situation has its promise, as it is also fraught with the gravest of dangers. Since it is a governmental agency, we are in danger of looking upon the rulings of the commission as having a certain creative power and also absolute finality. It is so easy to legislate a price. The commission is in reality only a clearing-house of economic forces; its regulations at the last are, in effect, no more than collective bargains in which the parties to the bargain are not confined to those in court, but embrace all the public both in the present and of the future, so far as it may be interested

in the control of present tendencies. If this court properly understands its functions, within reason, it will render easy and not hard changes in rates both up and down. It will not extend too widely the application in detail of single principles; it will be alert at all times to avoid the danger of our economic system crystallizing. Principles may be determined with finality, but price determinations, which are the peculiar functions of this court, must have periodicity to meet changing conditions. Appreciating this distinction, the commission officially give notice that the decision just rendered is subject to revision on occasion.

The problem must not be minimized. The country's development and continued prosperity depend on the right solution. The terms of the problem are primarily commercial, its phases are those of the strife and greed of the market-place, the clash of interests and classes, the arrogance of power, the despair of weakness; but like all grave questions it reaches to underlying economic and moral issues. A new era is upon us. We need statesmanship in railroad business, leaders with clear conceptions of the national and human phases of the problem and whose sincerity and patriotism shall command confidence. Such leadership is equally in demand among railroad presidents and boards of directors, among labor leaders, among publicists, and those who essay to perform the heavy function of trusteeship in our courts and public offices. The railroad on its part must meet the commission half-way with an intelligent theory of the new situation which is to be evolved and in a spirit of candor and co-operation.

The rate case was nominally an issue between two groups of railroads, on the one hand, and opposing shippers on the other hand, but the stability of American railroad credit, the character of public investment, the flexibility of capital as an agent of economic expansion, the nature and potency of competition to evolve the economic efficients, have all received an impress which for good or for bad will greatly influence our affairs for a long time to come.

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